No. 83-198

In the Supreme Court of the United States

OCTOBER TERM, 1983

BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION, PETITIONER

v.

FEDERAL DEPOSIT INSURANCE CORPORATION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether the court of appeals correctly held that petitioner, a holder of a subordinated capital note of an insolvent bank in receivership, could not set off that subordinated claim against its obligation on a deposit of the receivership.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A20) is reported at 701 F.2d 831. No formal opinion was issued by the district court, but the transcript of the July 17, 1981, hearing is set forth at Pet. App. A21-A48.

JURISDICTION

The judgment of the court of appeals was entered on March 18, 1983 (Pet. App. A1). A petition for rehearing was denied on May 6, 1983 (Pet. App. A49). The petition for a writ of certiorari was filed on August 4, 1983. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Banco Credito y Ahorro Ponceno ("Banco Credito") was a banking corporation organized and existing under the laws of the Commonwealth of Puerto Rico and regulated by the Secretary of the Treasury of the Commonwealth of Puerto Rico ("Secretary"). Its deposits were insured by the Federal Deposit Insurance Corporation ("FDIC").

On November 1, 1973, Banco Credito, for the purposes of strengthening its capital, submitted to the Secretary an application for permission to issue capital notes to a consortium of various banks led by petitioner, including a capital note to petitioner itself in the sum of $5 million (Pet. App. A1-A2). Puerto Rican law provides that such capital notes may be issued only with the approval of the Secretary and that they are "subject in right to the obligations with the depositors and other creditors of the issuing bank * * *." P.R. Laws Ann. tit. 7, § 111(*o*) (1981) (reprinted at Pet. App. A53). Moreover, Regulation No. 4 of the Secretary (see Pet. App. A53-A55) provides that such notes are subordinate in their rights to the claims of depositors and other creditors and that the Secretary is authorized to suspend the obligations of the issuing bank under certain specified circumstances to protect the public interest.

On December 27, 1973, Banco Credito and petitioner entered into a note purchase agreement, which incorporated the requirements of Regulation No. 4. The agreement noted that the funds were to be used to improve the ratio of Banco Credito's capital funds to its deposits. The agreement also contained a clause providing that "[n]othing in this agreement shall be deemed any waiver or prohibition of [petitioner's] right of banker's lien or setoff." On December 28, 1973, Banco Credito executed a subordinated capital note in favor of petitioner in the principal amount of $5 million. See Pet. App. A2.

Banco Credito made timely payments on the note until June 24, 1977, when the Secretary, acting pursuant to Regulation No. 4 and the terms of the note, ordered further payments suspended. On March 31, 1978, Banco Credito was declared insolvent by the Secretary and, pursuant to P.R. Laws Ann. tit. 7, § 201 (1981), the Secretary assumed control of Banco Credito for the purpose of its total liquidation. The FDIC was appointed as receiver pursuant to 12 U.S.C. 1821(e). Pet. App. A3-A4.

The FDIC embarked upon the liquidation of Banco Credito through a "purchase and assumption" arrangement under which the FDIC sold certain marketable assets of Banco Credito to Banco Popular, another Puerto Rican bank. See 12 U.S.C. 1823(e). Among the assets purchased by Banco Popular was approximately $1 million that Banco Credito had on deposit with petitioner. When Banco Popular asked to withdraw these funds, petitioner refused the request on the ground that the deposits were being applied as a setoff against the Banco Credito subordinated capital note obligation. Pursuant to the purchase and assumption agreement, the receivable represented by the deposit—being uncollectable — was returned to the FDIC, and was subsequently purchased by the FDIC in its corporate capacity. Pet. App. A3-A4.

2. The FDIC brought this action in the United States District Court for the Northern District of California seeking to recover the funds that Banco Credito had on deposit with petitioner. The district court granted summary judgment for petitioner on the ground that the note purchase agreement explicitly preserved petitioner's right of setoff (Pet. App. A21-A48). The court of appeals reversed (*id.* at A1-A20). The court held that federal common law was applicable, but that, because no rule of federal common law addressed this situation, other sources of law were relevant (*id.* at A5-A6). Looking to the Puerto Rican law embodied

in the note agreement, the court explained that the purpose of the subordination provision was to protect the rights of depositors and to elevate their claims unmistakably above those of an investor providing capital to a bank. Hence, petitioner would not ordinarily have a right to set off its deposits against the unpaid capital note because that would effectively destroy the subordination provision (*id.* at A8-A17). Finally, the court concluded that the setoff provision in the agreement could not operate to alter this subordination (*id.* at A18-A20).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court. The court of appeals' decision simply follows the longstanding rule that capital of a bank receivership may not be appropriated through setoff by a debtor of the receivership to pay another obligation due the debtor. The decision raises no legal issue of general applicability, and review by this Court is unwarranted.

1. Petitioner contends (Pet. 6-17) that the court of appeals erred in not permitting it to confiscate Banco Credito's deposits as a setoff against the money due on the subordinated capital note. In fact, the court simply applied well known and basic principles of banking law and subordination.

The critical fact in this case is that the capital note obligation owed to petitioner was to be subordinated in all rights to the bank's depositors and other creditors. This subordination was expressly required by Puerto Rican law in Section 111(*o*) and Regulation No. 4, and was explicitly incorporated in the provisions of the note purchase agreement. Moreover, as was well known to the parties to the agreement, the subordination feature was essential to accomplish the purpose of shoring up the inadequate capitalization of the bank. See Pet. App. A15-A16.

It is therefore undisputed that petitioner had no right to collect its note obligation from the assets of the receivership before the claims of other creditors. Petitioner now seeks to avoid this limitation by means of a setoff, taking advantage of the happenstance that Banco Credito had some of its funds on deposit with petitioner. The result sought by petitioner would circumvent the subordination required by law and incorporated in the capital note agreement — to the detriment of the depositors supposedly protected by the capital note. Indeed, as the court of appeals noted (Pet. App. A19), upholding petitioner's position could open the possibility of deliberate deposits in the bank holding capital notes that would, unbeknownst to the creditors supposedly protected by the capital note, completely neutralize the subordination requirement and undermine the capitalization of the bank.

The result reached below is consistent with general principles concerning setoffs against claims asserted by receivers of an insolvent company. In *Sawyer* v. *Hoag*, 84 U.S. 610 (1873), a shareholder of an insolvent insurance company sought to set off his obligation on a note he had given to the company (in payment for stock) against his claim under an insurance policy issued to him by the company. The Court refused to permit the setoff, explaining (84 U.S. at 622):

> The debt which the appellant owed for his stock was a trust fund devoted to the payment of all creditors of the company. As soon as the company became insolvent, and this fact became known to the appellant, the right of set-off for an ordinary debt to its full amount ceased. It became a fund belonging equally in equity to all the creditors, and could not be appropriated by the debtor to the exclusive payment of his own claim.

See also *Bausman* v. *Kinnear*, 79 F. 172, 174 (9th Cir. 1897) ("The debt due to a stockholder is entitled to no preference over other debts, and he cannot require its payments by way of set-off, to the exclusion or postponement of other claims."); *Kaye* v. *Metz*, 186 Cal. 42, 198 P. 1047 (1921).

As the court of appeals noted (Pet. App. A13-A14), cases arising under former Section 63 of the National Bank Act (12 U.S.C. (1958 ed.) 63), which provided that shareholders of national banking associations could be assessed "for all contracts, debts, and engagements of such association, to the extent of the amount of their stock therein * * *," are also instructive here because of the analogy between a capital note holder and a stockholder. In *Wingate* v. *Orchard*, 75 F. 241 (9th Cir. 1896), the court rejected a shareholder's attempt to set off his deposit claim against an assessment action brought against him by the failed bank's receiver under Section 63. The court explained (75 F. at 242-243):

> Obviously, to permit a holder of stock in such a bank to offset against an assessment for the additional liability thus imposed upon him as such holder the amount of his deposits in the bank, in respect to which he is no more entitled than any other creditor, would be, in effect, to make him a preferred creditor.

Accord, *Roth* v. *Baldwin*, 74 F.2d 1003, 1004 (D.C. Cir. 1934), cert. denied, 295 U.S. 737 (1935). See also *Scott* v. *Deweese*, 181 U.S. 202, 213 (1901) (shareholder induced to purchase shares by fraud not entitled to redress at expense of creditors).

2. Petitioner relies (Pet. 8-10) on three cases permitting a setoff pursuant to Section 68 of the old Bankruptcy Act, which allowed setoffs of "mutual debts." 11 U.S.C. (1976 ed.) 108. These cases, however, are inapposite. Banks were expressly exempted from the provisions of the old Bankruptcy Act (11 U.S.C. (1976 ed.) 22), and this Court has

consistently held that the bankruptcy laws do not apply to bank liquidations. See, *e.g.*, *Merrill* v. *National Bank*, 173 U.S. 131 (1899); *Cook County National Bank* v. *United States*, 107 U.S. 445 (1883). See also *Corbin* v. *Federal Reserve Bank*, 629 F.2d 233 (2d Cir. 1980). The cases relied upon by petitioner interpreted a specific provision in the Bankruptcy Act and do not formulate a general principle applicable here. See *Rochelle* v. *United States*, 521 F.2d 844, 850 (5th Cir. 1975); *Allegaert* v. *Perot*, 466 F. Supp. 516, 518-519 (S.D.N.Y. 1978).

Moreover, as the court of appeals explained (Pet. App. A16-A17), the cases cited by petitioner did not involve the avoidance of a subordination that was critical to the original creation of the obligation. In fact, in *Sawyer* v. *Hoag*, *supra*, this Court expressly distinguished the sort of debts that could be set off under the Bankruptcy Act from a *capital* obligation intended to be devoted to securing all the creditors of a company. 84 U.S. at 622.[1]

Petitioner also contends (Pet. 10) that the decision below conflicts with *FDIC* v. *Louisiana National Bank*, 653 F.2d 927 (5th Cir. 1981). This contention is without merit.

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[1]Apparently because the court of appeals did not follow these cases, petitioner asserts (Pet. 6-8) that the court failed to follow the mandate of 12 U.S.C. 1819 and *D'Oench, Duhme & Co.* v. *FDIC*, 315 U.S. 447 (1947), to apply federal common law. The short answer to this assertion is that the court quite plainly stated that it was following *D'Oench* and applying federal law. Pet. App. A5. The court of appeals rejected the cases cited by petitioner because they were inapposite, not because federal law was inapplicable (see *id.* at A16-A17). Indeed, the court relied principally on federal authorities. Petitioner can point to no principle of federal common law inconsistent with the decision below; it surely cannot be maintained that the court was bound to ignore the subordination requirement written into the capital note agreement simply because it was required by Puerto Rican law. Moreover, the FDIC here stands in the shoes of the receiver of the failed bank, and Puerto Rican law obviously is relevant to the question of the proper distribution of the assets of a closed, insolvent Puerto Rican bank.

Although that case did involve a subordinated capital note, the issue before the court was when the default by the closed bank occurred. The court expressly stated that it would not decide whether a subordinated claim could be set off. See 653 F.2d at 930.[2]

Finally, there is no merit to petitioner's contention (Pet. 14-17) that, regardless of general setoff principles, the setoff clause in the note purchase agreement authorized it to appropriate the deposits of the Banco Credito receivership to pay its subordinated claim. The setoff provision by its terms merely preserved existing rights of setoff, which, as explained above, should not be interpreted to allow a subordinated creditor to nullify the subordination provision. Even if the provision was intended by petitioner to override the subordination provision, the court of appeals correctly concluded that the approval of the agreement by the Secretary could not operate to negate the subordination required by statute. See Pet. App. A19-A20.

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[2]Petitioner's contention (Pet. 10-12) that *Chase Manhattan Bank* v. *FDIC*, 554 F. Supp. 251 (W.D. Okla. 1983), is inconsistent with the decision below is mistaken. That case involved a setoff, but not a subordinated claim, and thus did not concern the issue presented here.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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